- The $2,000 limit is supported by the new regulatory environment that eventually will open all aspects of the telecommunications network to competition.

The FCC excluded personal computer assets recorded in Account 2124, "General Purpose Computers," from the above expense limit increase however. The Commission justified this action as follows:

> "We expect purchases of PC components to assume increased significance as incumbent local exchange carriers expand their operations to offer additional nonregulated, competitive telecommunications services. To protect regulated ratepayers from bearing the costs of PC components used in nonregulated activities we leave the expense limit for PC components falling within Account 2124, General purpose computers, at the present $500 level. A $500 expense limit will require carriers to keep continuing property records ("CPRs") for a large majority of PC components. Accordingly, our ability to track transfers of PC components will be enhanced through the use of our affiliate transactions rules, thereby helping prevent abuses of these types of transfers. The continued necessity of this lower expense limit for PC components will be examined when the next increase of the expense limit is proposed."[30]

There are no such expense limits for network plant assets, however. Small value components of network assets must, in essence, be tracked to the penny. Clearly the costs of tracking such assets must outweigh the benefit derived therefrom.

<u>Depreciation Processes</u>

Section 32.2000 also prescribes depreciation accounting. Depreciation rates are to be calculated using a group plan (composite basis) of accounting and be applied on a straight-line basis over the life of the plant assets. The FCC approves for each LEC the depreciation rates to be applied against the various plant balances used in providing interstate services. The rate approval process, generally referred to as the represcription of depreciation rates, historically occurred every three years or more often if special circumstances dictate. Depreciation rates for intrastate purposes are set by the respective State Commissions, as dictated by the U.S. Supreme Court in *Louisiana Public Service Commission v. FCC*.[31]

Currently, the FCC allows the use of one depreciation method, which is the straight-line method. Various straight-line depreciation methodologies have been allowed historically, including the straight-line whole-life ("traditional" straight-line), remaining life and equal life group methods. VAL, another form of straight-line depreciation that

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[30] Expense Limits Order, ¶ 10.

[31] <u>Louisiana Public Service Commission v. F.C.C.</u>, 476 U.S. 355, 375, n. 4 (1986) [hereinafter Louisiana PSC].

involves the amortization of vintage groups of assets to expense and negates the need to track and retire individual assets on a detailed basis, has also been authorized by regulators in several State jurisdictions but has not been allowed to date by the FCC. The straight-line method of depreciation must be applied to all assets in the CPR. GAAP allows other methods of depreciation to be used, however. GAAP prescribes that depreciation should be calculated such that the historical cost of assets is allocated to expense over the asset's useful life in a systematic and rational manner. The most common method other than straight-line is accelerated, which can be applied as double-declining balance and sum-of-the-years digits, among others.

Under traditional rate of return regulation, the regulation of depreciation rates and methods has been critical to allowing the FCC and State regulators to accomplish their regulatory and universal service objectives. Depreciation lives have historically been set for regulatory accounting purposes in excess of the true economic lives of assets based upon the use of historic retirement data. As noted above, when the large LECs discontinued the application of SFAS No. 71, billions of dollars in write-downs of telecommunications plant asset balances to their estimated net realizable value were recorded for external reporting purposes. These write-downs were caused by the prescription of inadequate depreciation practices over time. In some states, such practices also result in the LECs having to pay higher property taxes than they otherwise might due to the overstatement of the net book value of plant assets.

Such depreciation practices are no longer practical in the current price cap regulatory environment, where prices of services are regulated as opposed to the costs incurred to provide such services. The LECs should be relieved from the costs associated with the depreciation represcription process and should be allowed to implement depreciation practices and methods consistent with "best practice" companies under GAAP.

The Changing Need for Asset Management Information

As discussed in Section III. above, the telecommunications industry has undergone significant changes with respect to competition and regulation over the past ten years. Among these changes was a shift in the form of regulation applied to dominant carriers by the FCC and the majority of State Commissions from traditional rate of return regulation to price cap regulation.

The Section 32.2000 rules were designed under traditional rate of return regulation, where details of telecommunications plant asset balances were critical to the assessment of the propriety of each carrier's regulated rate base upon which a return on investment could be earned. The regulation of depreciation rates and methods was also critical in this environment to allowing the FCC and State regulators to accomplish their regulatory and universal service objectives. Detailed plant accounting records were used in large part to determine the average service life of assets in order to set depreciation rates.

In a price cap regulatory environment, however, such plant accounting detail is no longer of paramount importance as prices charged for regulated services are regulated instead of the costs incurred and plant investment utilized to provide such services. In the same manner, the detailed depreciation rate represcription process is no longer cost-beneficial, as costs no longer have a direct bearing on the determination of prices under price caps.

Complying with the rules set forth in Section 32.2000 is costly for the LECs. A major factor in the determination to change to price cap regulation was the premise that LECs should be incented to control costs as other companies do in more competitive industries. Many of the FCC's rules, including the rules set forth in Section 32.2000, have a direct impact on LECs' costs. These rules were not changed, however, when price cap regulation was implemented.

While the LECs must currently apply the procedures described in Section 32.2000 in order to comply with such regulations, these procedures are not, in most cases, beneficial to the LECs for purposes of managing their assets or running their business. In those instances, the LECs must bear additional costs (on top of the Section 32.2000 compliance costs) to capture and provide the information necessary to more effectively manage the business.

All companies, including the LECs, must maintain sufficient internal controls in order to safeguard assets and ensure that their financial accounts and records are accurately stated as prescribed by rules promulgated by the SEC, GAAP and the Internal Revenue Service ("IRS"). In order to comply with these standards, the LECs apply internal and external measures, including:

- Undergoing an annual audit performed by independent public accountants which, among other things, assesses the adequacy of internal controls,
- Utilizing internal auditors to periodically assess the internal control structure surrounding the accounting for telecommunications plant assets and depreciation practices, including the physical verification of assets, and
- Reporting on the results of operations and financial position of the Company, including the adequacy of internal controls, to the Audit Committee of the Board of Directors.

Further, it is good business practice to maintain adequate internal controls which allow the LECs to evaluate the economic health of the business (e.g., internal rates of return) and to determine which products and services should be offered.

Comparison with Other Industries

As described in Section III. above, in conjunction with the preparation of this paper, Arthur Andersen accumulated certain information from other capital-intensive companies of similar size operating in industries outside of the regulated telecommunications industry. The following information in the plant accounting and recordkeeping area was accumulated to compare the LEC Coalition's accounting and recordkeeping practices under Part 32 with those of other companies under GAAP and to assess the LECs' costs of compliance with the Part 32.2000 rules:

	LECs		Non-Telcos	
	Range	Average	Range	Average
Full-time equivalents (FTEs) involved in fixed asset and depreciation accounting	46 - 165	121	3 - 37	27
Cost of FTEs for fixed asset and depreciation accounting ($000s)	$3,450 – 12,375	$9,075	$225 - 2,775	$2,025
Expense limits	$0-2,000*	N/A	$1,000-25,000	NA

* - The $2,000 expense limit applies only to general support assets other than computers. The expense limit for general purpose computer equipment is $500. There is no expense limit for network plant assets (i.e., all costs must be capitalized regardless of magnitude).

As the information above demonstrates, the LECs are saddled with extremely high costs to manage their fixed assets due to the detailed requirements of Section 32.2000. The number of property units that the Coalition LECs must track and account for, generally greater than 50 million units per company, is far greater than the corresponding number of property units deployed by other nonregulated companies, generally less than 1 million. Obviously, the LECs' costs could be reduced and, as intended by the Telecommunications Act, the LECs could become more competitive if the rules of Section 32.2000 were eliminated or simplified. As discussed above, the rules of Section 32.2000 do little to protect the public interest, particularly under price cap regulation.

Recommendations

The intent of the Telecommunications Act was to create a competitive marketplace in the communications industry. To that end, regulations should ultimately be eliminated, and the LECs should be free to manage their operations in a manner that promotes competitive initiatives. There are sufficient regulations imposed by the SEC and other legislation (e.g., Foreign Corrupt Practices Act) which protect consumers' and shareholders' interests. All companies in the United States must abide by these regulations, and to place additional regulatory burden on the LECs is anti-competitive. Furthermore, the rules defined in Section 32.2000 are obsolete in that they were designed to determine rates under traditional rate of return regulation.

The LECs should be allowed to manage their property and depreciation policies and accounts with the same flexibility afforded to competitive companies. There is no discernable benefit derived from the information that is provided by the rules of Section 32.2000. In fact, the costs of complying with these rules hinder the ability of the LECs to operate their businesses effectively and at the lowest cost possible. This phenomenon is detrimental to both the public interest and shareholders. Complying with these outdated rules detracts from the LECs' ability to quickly respond to the dynamics of today's telecommunications environment. The LECs require the flexibility to modify existing processes and procedures to become more responsive to customers' demands. Elimination of the rules in Section 32.2000 will facilitate the migration toward flexibility and competitiveness.

Recognizing the significant changes recommended above, there are a number of improvements that can be made now to the Section 32.2000 rules impacting the Coalition LECs. These changes are designed to promote cost reductions and, in turn, increase competitiveness, which will facilitate a transition to achieving the ultimate goal of eliminating the rules in their entirety.

<u>Redefining Property Units</u> - Currently, Section 32.2000 requires the LECs to maintain detailed information with respect to property record units at a very low level. The cost of tracking information at this level is excessive when compared to the benefit derived. Due to the volume of transactions that must be tracked by the LECs, the detailed requirements of Section 32.2000 are excessive and burdensome. Allowing the LECs to consolidate certain plant accounts (e.g., analog and digital switching equipment), eliminate excessive subaccount and subsidiary record requirements (e.g., no requirement to distinguish cable and wire between metallic and non-metallic), and roll-up CPR units into higher-level retirement units (e.g., an entire vintage of office furniture instead of separate asset identification for each piece of equipment) would ease the recordkeeping and tracking burdens currently experienced by the LECs and provide increased flexibility. Certain low-value asset costs should be combined with the costs of other assets and not tracked separately. These changes are necessary to allow the LECs to embrace and foster competition, while being a viable competitor. Current requirements do not afford the LECs the opportunity to compete cost-effectively.

The LECs should be allowed to define property units at a level necessary to manage the business, nothing more. For example, in the airline industry, the relevant property units are engines and airframes – within the airframes category, the seats, carpeting, wings, instrument panels, etc. are not tracked nor retired as separate units of property. Thus, management can assess the performance of each airplane and not bother with the accumulation or tracking of parts that do not function individually to produce revenues.

For telecommunications companies, the equivalent would be to only require tracking of assets at the central office level. As current detailed property unit information is not used by the FCC or most State Commissions in determining prices, continued regulation of this information has no practical significance.

BPR and CPR Requirements – Pursuant to Section 32.2000, the LECs must file any proposed modifications to the BPR and CPR with the FCC. This process adds unnecessary resource requirements and costs to the LECs, particularly in light of the decreased relevance of this information under price cap regulation. To the extent that technology and/or the needs of the business change, corresponding changes in the way in which assets are managed and accounted for should also be made without regulatory delay. Additionally, the LECs should not have to track assets at levels that add no value to managing the business. Currently, personnel resources and costs are expended to track the detailed information required by Section 32.2000, which detracts from the time which could be spent more effectively on other value-added, customer-focused activities.

Tracking assets by location is a reasonable activity and is followed by most businesses. Similarly, the LECs have no reason to record in the financial or accounting systems the exact location, by bay or rack/shelf/position or slot for instance. The purpose of the rule is to ensure the existence of assets to support the investment on the LECs' books. If an asset is in service, but its specific location is in some way different than the location indicated in the CPR, the books of the LECs are still properly stated. Tracking the location of assets on an overly detailed basis is not useful for business purposes nor is it required to properly state the financial records of the LECs. The LECs should have the flexibility to define the "location" by which they desire to track assets for business purposes. For example, tracking central office assets (including plug-in cards) by central office could be an alternative.

The LECs should be allowed the flexibility to track assets at a reasonable level at which they manage assets to run the business. A real benefit from simplifying Section 32.2000 is the flexibility to choose how to track assets for business purposes. The LECs will track and verify investment in plant and maintain controls for business reasons. As an example, certain systems are duplicated today which track the same types of data. Engineers use one system for business purposes, while accountants use another system for purposes of complying with Section 32.2000.

In addition, tracking CPR detail under today's environment is cost-prohibitive and an operational hindrance. The LECs should be afforded the opportunity to upgrade and move to a more real-time "inventory management" process, especially as it relates to plug-in cards and to central office hardwired assets. The required detail record keeping hinders the LEC's ability to timely manage and react to its inventory deployment requirements. The Section 32.2000 requirements provide an obstacle to effectively managing operations. Elimination of the detailed rules in Section 32.2000 would result in more efficient and effective management of the business rather than the detailed tracking which management does not use for purposes other than complying with the USOA regulations.

Recommendations for immediate reductions in specific CPR detail include the following:

- Track all assets on an average cost basis and eliminate the need to track certain assets by actual cost and location.

- Eliminate the requirement for allocation of indirect non-material costs to each CPR unit and allow other appropriate cost recognition, such as capitalizing at the account level or expensing.

- Eliminate the requirement to track the age of existing assets in the CPR and the service life of property retired in the supporting records to the CPR. The cost to track this information is certainly higher than the benefit derived therefrom. Technology has developed at such a pace that assets that were once long-lived have been transformed to assets with relatively short service lives. This data has been used traditionally to assist in setting depreciation rates, and using historical data for setting depreciation rates is not as useful as it once was.

- Eliminate the requirement to maintain the current level of detail support records and the requirement to maintain this detail beyond the point of retiring the assets.

- Simplify the recordkeeping interpretations of the Accounting Safeguards Division staff affording the opportunity to identify fewer records.

Since LECs have been charged to open their networks to competitors, they should be allowed to account for their assets similar to other competitive companies. The rules in Section 32.2000 are not conducive to competition, as indicated by the accounting policies and procedures of unregulated companies, which do not track their assets in such a detailed manner.

Depreciation – As discussed earlier, the depreciation rules in Section 32.2000 were designed under traditional rate of return regulation. The FCC no longer uses this policy to set rates for the Coalition LECs. Price cap regulation eliminates the need for the current depreciation rules.

The FCC should decline any further involvement with respect to depreciation. The LECs should be able to select their methods, lives and rates based on economic analysis consistent with other industries. Much time and effort is currently expended by the LECs in performing depreciation studies as well as in tracking and reconciling depreciation recorded in the Part 32 regulatory books of account versus depreciation recorded in the external financial statements prepared on a GAAP basis. These efforts are unnecessary, as there is an abundance of data available to determine economic lives for GAAP purposes and, in theory, there should be no difference between regulatory lives and economic lives for depreciation.

Finally, the LECs should be able to choose the depreciation method which best reflects the use of particular asset types to provide services and produce revenues. In certain circumstances, accelerated depreciation is the most representative depreciation method in this regard, since the value of many asset types is significantly expended during the first years the asset is in service.

VAL is also an acceptable approach for depreciation, especially in regard to general support assets. The LECs spend a disproportionate amount of time tracking and depreciating assets with a relatively small investment balance. Certain LECs have estimated that 25-30% of the time required to track fixed assets is spent for general support assets, which represent only 3-5% of the total investment in fixed assets. Employing the VAL method of depreciation for these assets would eliminate a significant portion of the time and cost spent to track these lower-valued assets. The LECs would continue to apply appropriate asset safeguarding measures with respect to these assets. This approach has been accepted by many State Commissions and other regulatory agencies and meets the GAAP requirement for depreciation (i.e., a systematic and rational allocation of cost). The potential cost savings from adopting the VAL method include:

- Removing the need to identify, track, and inventory large amounts of retirement units with small unit costs which are not an integral part of providing telecommunications service, .
- Eliminating the need for office and field procedures to monitor and record retirements of low-value equipment,
- Freeing up time of employees for more meaningful and material tasks, and
- Reducing systems processing time.

<u>Expense Limits</u> – The FCC's increase in the capitalization limit for general support assets other than computers was certainly a step in the right direction. However, the FCC should take the concept further to include all fixed assets. There is no regulatory need for certain items to be recorded as assets regardless of value. The LECs expend great time and effort tracking low-cost items – there are a significant amount of network assets that cost less than $500 that are a significant burden to track. The LECs could realize tremendous savings if the FCC would extend the expense limit to all assets. If such costs could be expensed, substantial time and effort and resulting cost savings could be realized.

The FCC adopted the higher expense limit in lieu of the LECs' request to use VAL for general support assets. The arguments for VAL are still valid. There are still excessive costs incurred in tracking assets with values over $2,000. VAL would provide additional administrative savings and properly allocate costs to the proper accounting periods.

The FCC should also consider eliminating its involvement in setting expense limits. Expense limits are merely an accounting convention to be used for expediency purposes when the costs to be expensed do not have a material effect on the financial statements, taken as a whole (i.e., the expense limit is reasonable), and the costs to record, track and depreciate low-dollar value assets exceed the benefit of capitalizing such costs. GAAP provides an adequate safeguard to prevent excessive expense limits that would cause distortions in reported financial results.

The LECs should be allowed to choose appropriate expense limits under the relevant circumstances. In such a capital-intensive industry as telecommunications, it makes little sense to require capitalizing low-value items as is currently required. The LECs should be allowed to choose expense limits that balance the need to effectively measure business performance (e.g., return on investment) with the savings reaped from reduced asset tracking costs. Management of the LECs, not the FCC, should make this determination. As has already been established, the FCC does not require the detailed information of fixed assets under a price cap regime.

VI. AFFILIATE TRANSACTIONS

Overall Summary Recommendations

The affiliate transaction rules contained in Section 32.27 of the USOA are unduly complex and require carriers to incur significant costs in order to comply with such rules. While relevant in the traditional rate of return regulation environment, the Section 32.27 rules (and related cross-subsidy concerns) are clearly less relevant under price cap regulation.

In the long-term, GAAP should be relied on in this area with minimum regulatory intervention. There are opportunities for changes now in the affiliate transaction requirements, such as:

- Eliminate the asymmetrical affiliate transaction rules with respect to the provision of services between regulated and nonregulated affiliates.
- Eliminate the application of the 50% threshold on a product-by-product and service-by-service basis, for determining the existence of a "substantial" third party market and the validity of using prevailing market prices for affiliate transactions.
- Implement a materiality-based and/or rotational requirement for performing fair market value studies in order to limit the costs of compliance.
- Expand the exemption provided in paragraph 148 of the Accounting Safeguards Order (that allows nonregulated affiliates of the LEC that *exist solely* to provide services to members of the affiliated group to price such services at cost) to:
  - Support services provided *to* affiliates that exist solely to provide services within the affiliated group
  - Specific product/service lines offered only to affiliates

Background on the Section 32.27[32] Affiliate Transaction Rules

The affiliate transaction rules contained in Section 32.27 of the USOA provide specific standards governing transactions between regulated carriers and their nonregulated affiliates. Affiliate transactions are required to be accounted for in the regulated books of account as follows:

- Services offered by regulated carriers to customers under Federal or state tariffs are charged to nonregulated affiliates at the same tariff rates.

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[32] 47 CFR §32.27

- Services provided which are equivalent to those included in publicly filed interconnection agreements may be provided at such publicly filed prices.

- For transactions other than those above, if there are substantial sales to unaffiliated third parties (greater than 50% of the revenues from such products or services are derived from third parties), the prevailing prices for those products or services are also used to value like transactions with affiliates.

- If prevailing prices do not exist, transactions are recorded at the fully distributed cost ("FDC") of the entity that provides a service or transfers an asset to an affiliate. As recently modified by the FCC's Accounting Safeguards Order, services provided/assets transferred **by** regulated carriers to nonregulated affiliates are recorded at the **higher** of FDC/net book cost or fair market value ("FMV"). Services provided/assets transferred **to** regulated carriers from nonregulated affiliates are recorded at the **lower** of FDC/net book cost or FMV. In the case of services only, nonregulated affiliates that exist solely to provide services to members of the affiliate group are exempt from the above FMV requirements and are required to follow the FDC standard only.

The affiliate transaction rules were adopted by the FCC effective January 1, 1988, as prescribed in the Joint Cost Order. In the Joint Cost Order, the FCC stated that "Our goal in establishing standards for transactions between affiliates is to prevent cost shifting to ratepayers by means of improper transfer pricing."[33] The Commission goes on to state that "the absence of such standards would create a loophole that would call into question our ability to regulate."[34] Finally, the FCC notes that "The affiliate transactions requirements are a key part of our deregulatory effort and should be a small price for the carriers subject to our jurisdiction to pay in this regard."[35]

All of the above arguments made in support of the Section 32.27 affiliate transaction rules, while relevant in the traditional rate of return regulation environment, are clearly less relevant under the current interstate price cap regulatory model. Each of the above statements, as well as the comments of the Department of Justice quoted by the FCC in the Joint Cost Order[36], emphasize the potential for increased "cost" of regulated products or "loss" to the regulated business resulting from the regulated carrier purchasing products or services from nonregulated affiliates at too high a price or selling such products and services to nonregulated affiliates at too low a price, respectively. Such pricing would have resulted in increased regulated revenue requirements to be recovered from ratepayers under rate of return regulation. Under price cap regulation, prices are regulated, not based on the costs incurred to provide

[33] Joint Cost Order, ¶ 290
[34] Joint Cost Order, ¶ 291
[35] Joint Cost Order, ¶ 292
[36] Joint Cost Order, ¶ 290

such services, but based on general economic indices of inflation and productivity. Thus, the incentives to over- or under-price affiliate transactions are minimized.

Changes Mandated by the Accounting Safeguards Order

In conjunction with its implementation of the accounting safeguards under the Telecommunications Act, the FCC modified the affiliate transaction rules with respect to the provision of services between regulated and nonregulated affiliates and the use of prevailing market prices in its Accounting Safeguards Order.

Asymmetrical Affiliate Transaction Rules -

In its Accounting Safeguards Order, the Commission imposed additional FMV requirements on services provided between affiliates. These additional requirements were justified under the theory that "ratepayers may be harmed if the carrier's smaller profits or increased costs as a result of our services valuation rules are reflected in rates for regulated telecommunications services."[37]

These asymmetrical standards adopted by the FCC favor regulated operations and may discourage transactions with nonregulated affiliates/activities. The FCC acknowledged this when it observed that "If our rules have an adverse effect on potential transactions [with affiliates], we believe that, on balance, prevention of cost shifting is the more important goal."[38]

The bias in favor of regulated services can be seen in the following illustrative application of the affiliate transaction asset transfer rules. Assume there are two identical buildings, one is owned by a regulated LEC and the other by a nonregulated affiliate or division of the LEC. If the regulated LEC transferred its building to the nonregulated affiliate, under the FCC's affiliate transaction rules, it would record the transaction at the **higher** of the building's net book cost or its fair market value. Assuming that the fair market value is ***higher*** than the depreciated net book value of the building on the regulated LEC's books, the resulting gain realized upon transfer of the building would usually accrue to the benefit of the ILEC's customers of regulated services. On the other hand, if the nonregulated affiliate/division transferred an identical building to the regulated LEC, the LEC could record only the ***lower*** of the affiliate's net book cost for the building or its fair market value. The asset transfer rules, and effective August 12, 1997, the affiliate services rules as well, present a "heads I win, tails you lose" proposition for customers of the LEC's regulated services.

[37] Accounting Safeguards Order, ¶ 145

[38] *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, Order on Reconsideration, CC Docket No. 86-111, 2 FCC Rcd, 6283, (1987), ¶ 117 [hereinafter Joint Cost Reconsideration Order].

In the Joint Cost Reconsideration Order, many parties argued against this inequitable treatment:

> "In the normal regulatory scheme, AT&T argues, it is the ratepayers who bear the risk of loss on regulated assets. AT&T argues that the residual affiliate transaction rules invert the normal regulatory relationships because ratepayers become insulated from loss while shareholders lose the opportunity for full recovery of their investment."[39]
>
> "AT&T, Ameritech, NYNEX, SNET and Southwestern assert that the rule will discourage intracorporate transactions, and will force carriers to buy from or sell to outside parties.
>
> AT&T argues that the rule fails to reflect the reality that investors always bear the risk on nonregulated investments.
>
> Ameritech and U S WEST argue that it is unfair to require some transfers to occur at net book cost because, for carriers, net book has been artificially inflated by less-than-adequate depreciation rates.
>
> BellSouth argues that the rules operate as a subsidy for the regulated activity. Subsidies are inconsistent with the highly competitive nature of nonregulated enterprises, BellSouth argues, and would therefore have the effect of creating incentives for carriers to avoid affiliate transactions in favor of third party transactions."[40]

The Commission's response to the above arguments was that:

> "This Commission is not the guardian of the nonregulated entity, its consumers or its shareholders, even though its shareholders and those of the regulated entity are one and the same.
>
> Thus, the balancing of ratepayer and shareholder interests which the carriers urge upon us bears no relationship to our statutory responsibilities in fashioning a rule for assets transferred into regulation."[41]

These arguments clearly deserve revisiting in light of the changes in the industry environment and changes in the regulatory method by which the Coalition LECs' rates are determined in the interstate and the majority of state jurisdictions. The fears of cross-subsidy of nonregulated activities and "manipulation of transfer prices" to the

[39] Joint Cost Reconsideration Order, ¶ 95.
[40] Joint Cost Reconsideration Order, ¶ 98.
[41] Joint Cost Reconsideration Order, ¶ 116.

detriment of the regulated ratepayer are mitigated under price cap regulation where rates charged for regulated services are no longer cost-based.

Use of Prevailing Company Prices –

The Accounting Safeguards Order also "clarified" when the application of the prevailing price valuation method to transfers of particular assets or services between regulated carriers and nonregulated affiliates was appropriate. The FCC concluded that its "substantial" third party market rule adopted in the Joint Cost Order for establishment of a true prevailing price was unclear and thus established the requirement that "annual sales, as measured by quantity, of greater than 50 percent of a particular product or service to third parties must occur to satisfy the requirement that there be a "substantial" amount of outside business in order to produce a true prevailing price for that particular product or service."[42]

The above clarification has resulted in significant cost increases for the LECs, as most carriers (and their nonregulated affiliates) had not tracked product sales at the new required level of specificity. Thus, carriers were faced with a dilemma – to modify their systems to track sales at this detailed level or to determine instead the FDC and FMV of individual products and services that were formerly valued at prevailing price. In either case, the cost of compliance was great with little discernable benefit, particularly in today's price cap regulatory environment.

Accounting Safeguards Order Compliance Activities –

We collected the following information from each of the Coalition LECs with respect to the impacts of adopting the new affiliate transaction rules as discussed above. The Coalition LECs provided the following data:

[42] Accounting Safeguards Order, ¶ 135.

	Range	Average
	($000s)	($000s)
Incremental compliance cost of rule changes as a result of Accounting Safeguards Order	$250 - 1,200	$650
Gross adjustments recorded to reflect the changes as a result of Accounting Safeguards Order	$1,000 - 28,500	$14,000
Total nonregulated expenses	$220,513 - 1,263,678	$837,458
% of gross FMV adjustments to total nonregulated expenses	0.1% - 2.5%	1.7%

This data shows that the net adjustments recorded by the Coalition LECs were insignificant to total nonregulated operations. Further, the cost of implementing the new affiliate transaction rules pursuant to the Accounting Safeguards Order was significant as compared to the magnitude of adjustments recorded.

Changes in the Affiliate Transactions Environment

As discussed in Section III., there have been many changes in regulation and in the telecommunications industry competitive landscape since the adoption of the affiliate transaction rules included in Section 32.27. The regulatory concerns with respect to potential harm to interstate ratepayers due to cross-subsidy of the carriers' ventures into nonregulated activities are mitigated greatly under price cap regulation. With the passage of the Telecommunications Act, the incumbent LECs are (or will be at some future date) allowed entry into or expansion within various telecommunications markets. The primary argument, as surfaced in the Accounting Safeguards Order, appears to be whether complicating or simplifying the accounting safeguards would best facilitate the incumbent LECs' entry into competitive markets. On one hand, the goal of prevention of cross-subsidy of nonregulated activities by regulated services must be maintained. On the other hand, arguments to streamline existing affiliate transaction rules must be considered in order to facilitate the entry of incumbent LECs into competitive markets.

Comparison with Other Industries

As described in Section III., in conjunction with the preparation of this whitepaper, Arthur Andersen accumulated the following "best practices" information to compare the LEC Coalition's affiliate transaction regulatory accounting requirements with the practices utilized in this area by nonregulated companies and assess the LECs' costs of compliance with the Part 32 affiliate transaction rules:

	LECs		Non-Telcos	
	Range	Average	Range	Average
Annual dollar volume of affiliate transactions (in millions)	$550 - 3,900	$1,675	N/A*	N/A*
Full-time equivalents (FTEs) involved in affiliate transactions	10 - 22	18	0 – 18	3.5
Cost of affiliate transaction FTEs (in millions)	$0.9 - 2.0	$1.6	$0 - 1.6	$0.3

* - Information on affiliate transaction volumes generally not available at non-telecommunications companies as it is not routinely tracked. Affiliate transaction volumes up to $8 Billion were reported by companies able to track such data.

As the information above represents, the LECs are saddled with high costs to manage their compliance activities under the Section 32.27 rules. These costs hinder the LECs' ability to effectively compete and ultimately disadvantage the regulated ratepayer and the shareholder. This harm arises due to the carriers' inability to redeploy resources tied up in compliance activities, such as compliance with the affiliate transaction rules as indicated above, to activities such as improving customer service, developing streamlined business processes and improving carrier productivity. This is additionally complicated by state regulation that mandates affiliate transaction rules difference than those promulgated by the FCC.

Companies outside the regulated telecommunications industry typically develop transfer prices for goods and services provided to/received from affiliates on either a cost or a market price basis. Companies operating in regulated industries also commonly price products provided under regulated tariff at the appropriate tariffed rate. Cost is normally determined on a "fully allocated" basis, roughly the equivalent to FDC as defined by the FCC.

Companies outside regulated industries are subject merely to the related party disclosure requirements under GAAP.[43] There is minimal guidance on accounting for related party transactions under GAAP. SFAS No. 57 provides guidance with respect to related party disclosures in the external financial statements. SEC requirements further prohibit the recognition of gains or the step-up in basis on the sales of assets among related parties under common control and only permit the recognition of losses when an impairment in value of the assets transferred is indicated. Antitrust considerations as well as partnership and other agreements may also impact the accounting for affiliate transactions and allocation of costs among affiliates. Subject to the above rules, nonregulated companies may account for affiliate transactions in various ways, as long as such accounting methods are fully disclosed in the financial statements. Thus,

[43] Statement of Financial Standards No. 57, "Related Party Disclosures" [hereinafter SFAS No. 57].

competitors to the LECs as well as entities operating in other competitive industries have maximum flexibility in the pricing of affiliate transactions, subject to the disclosure requirements noted above. All other things being equal, the costs of compliance with the Section 32.27 affiliate transaction rules put the LECs at a competitive disadvantage.

Recommendations

The intent of the Telecommunications Act was to create a competitive market place in the communications industry. To that end, regulations should ultimately be eliminated, and the LECs should be free to manage their operations in a manner that promotes competitive initiatives. The LECs ultimately should be allowed to manage their affiliate transactions with the same flexibility afforded to competitive companies with GAAP providing the guidelines to be followed. The costs of complying with these rules hinder the ability of the LECs to operate their businesses effectively and at the lowest cost possible. This phenomenon is detrimental to both the public interest and shareholders. Complying with these rules detracts from the LECs' ability to quickly respond to the dynamics of today's telecommunications environment. While the LECs expend time and resources to assess the impact of the affiliate transaction rules on a potential transaction, their competitors are able to take advantage of such opportunities without such delays. The LECs require the flexibility to modify existing processes and procedures to become more responsive to customers' demands. Elimination of the affiliate transaction rules in Section 32.27 will facilitate the migration toward flexibility and competitiveness.

Recognizing the significant changes recommended above, there are a number of short-term revisions that can be made to Section 32.27 that would be an improvement over today's environment. The FCC can take the following steps to relieve the LECs from certain detailed requirements and provide a roadmap for the LECs to transition to full GAAP reliance.

Eliminate the Asymmetrical Affiliate Transaction Rules - The Commission should reevaluate the benefits derived from the asymmetrical affiliate transaction rules in light of the costs incurred by the LECs to comply with such rules. The asymmetrical rules with respect to both transfers of assets and the provision of services between regulated and nonregulated affiliates should be eliminated. The relevance of such rules is dramatically reduced in the current price cap regulatory environment.

Modify Rules for Use of Prevailing Price - Similarly, the Commission should also eliminate the requirement to apply the 50% threshold on a product-by-product and service-by-service basis, for determining the existence of a "substantial" third party market and the validity of using prevailing market prices for affiliate transactions. This detailed application does not justify the costs of compliance and its relevance is reduced in the current price cap regulatory environment.

Provide Relief from Requirements to Perform Annual FMV Studies - As demonstrated above, the costs of compliance with the affiliate transaction rules are significant. The additional costs associated with the FMV study requirements prescribed by the Accounting Standards Order can be minimized somewhat by implementing a materiality-based and/or rotational requirement for performing such studies. FMV studies must currently be performed at the beginning of the contract period for services provided to affiliates over a long-term contract period (such as a long-term lease of building space or a contract to provide goods at a particular price) and annually for all other services. In order to reduce the cost of compliance, FMV studies for affiliate services should be performed:

- Only for services where annual billings to affiliates exceed a defined materiality threshold. A reasonable threshold for such purposes would be $1 million, the prescribed threshold used to evaluate proposed audit adjustments[44] in the independent cost allocation audits performed pursuant to Section 64.904.[45] All other services would be transferred at FDC.

- On a rotational basis. Again, guidance can be found in the FCC's audit guidelines where the independent auditors are directed to audit "immaterial" transactions between affiliates as well as cost pool and regulated/nonregulated cost apportionment studies at least once every three years.[46]

The above requirements are consistent with the affiliate transaction regulations in the State of California, where fair market value analyses are also required with respect to affiliate transactions. Pacific Bell is required to perform market pricing studies for all non-tariffed goods and services it provides to nonregulated affiliates except as follows:

> Market pricing studies are not required for goods or services which have an aggregate billing to all affiliates of less than $100,000 per year. Billings to Pacific and Nevada Bell shall not be counted toward the $100,000 threshold.
>
> Pacific may use the Consumer Price Index Factor to annually update the market prices derived from [the 13] studies it has already performed. A new market price study for each of those services will be due four years from the date of the original study.[47]

Thus, sufficient precedent exists at both the Federal and State levels to support the proposed short-term recommendation.

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[44] Letter from Jose'-Luis Rodriguez, Chief, FCC Audits Branch, to all Tier I Local Exchange Carriers, April 20, 1992, ¶ 11 [hereinafter Audit Guidance Letter].
[45] 47 CFR § 64.904.
[46] Audit Guidance Letter, ¶ 6.
[47] *Affiliate Transaction Decision*, Decision 87-12-067, 27 CPUC 2d 137.

Exemptions from FMV Determination - Expand the exemption provisions provided in paragraph 148 of the Accounting Safeguards Order. In paragraph 148, the Commission granted relief from the FMV requirements, allowing that affiliate service "transactions where a carrier purchases from its affiliate services that are neither tariffed nor subject to prevailing company prices and such affiliate exists solely to provide services to members of the carrier's corporate family should continue to be valued at fully distributed cost. We find that when an affiliate is established to provide services solely to the carrier's corporate family in an effort to take advantage of economies of scale and scope, the benefits of such economies of scale and scope are reflected in such affiliate's costs and are ultimately transferred to ratepayers through transactions with the carrier for such services valued at fully distributed costs. Requiring carriers to perform fair market valuations for such transactions would increase the cost to ratepayers while providing limited benefit."[48]

The FCC staff has interpreted the "exists solely" language in the above paragraph very literally. In other words, if an affiliate has but one sales transaction with a third party, then the exemption provided for in paragraph 148 would not apply. In that case, the lower of FDC or FMV valuation standard would apply to all products and services provided to the regulated carrier by that nonregulated affiliate. This literal interpretation is truly burdensome and costly. A nonregulated affiliate may provide many services to its corporate affiliates where economies of scale and scope are realized - however, that same affiliate may provide incidental or non-related services to third parties. For example, a nonregulated affiliate may provide procurement services only to corporate affiliates but may, in order to minimize its overall costs (thus benefiting the overall corporation), lease excess space in its facilities to third parties. In this instance, the existence of third party rental revenues should not "taint" the procurement services that are provided solely to affiliates and such procurement services should be valued at FDC without regard to FMV. We recommend that the FMV exemption be extended in these instances to specific product/service lines offered only to affiliates.

Similarly, services provided by the regulated carrier to affiliates that exist solely to provide services within the affiliated group should also be exempt from the FMV valuation requirements, as such transactions are for the most part rebilled to the LECs by the service company as a component of their costs of providing centralized services to affiliates. Thus, any difference between FDC and FMV would be captured in the exempt affiliate's costs and rebilled to the LEC, thus eliminating the impact of the original FMV accounting.

[48] Accounting Safeguards Order, ¶ 148.

VII. FUTURE ROLE OF REGULATORY OVERSIGHT

Regulatory Oversight Role of the FCC and State Commissions

The role of the FCC and State regulators has evolved over the past ten years since the implementation of Part 32. In 1988, Federal and state regulators were focused on the regulation of dominant carrier rates, accounting practices, depreciation rates and methods, service quality and technical standards, universal service and lifeline assistance programs, and ensuring that other social obligations relevant to the telecommunications industry were satisfied. Commissions also regulated carrier market entry and exit. Rate regulation was based on traditional cost-based, rate of return methods supported by extremely detailed accounting data.

In 1998, the FCC and State regulators are responsible for all of the above as well as the implementation of the Telecommunications Act. State Commissions have primary responsibility for arbitrating interconnection agreements and prescribing the rates and performance responsibilities of subject carriers. The Telecommunications Act reflects certain accounting and non-accounting safeguards associated with the transition from a regulated to a competitive, deregulated marketplace. The Act does not require continuation of outdated forms of regulation and reporting but encourages the revisiting of such regulations in order to provide for an efficient transition to a competitive, deregulatory environment. Price cap regulation of dominant incumbent LECs is utilized in the majority of jurisdictions in the current environment, whereas traditional rate of return regulation is still the common method of regulating the rates of smaller carriers.

The primary oversight role with respect to accounting and reporting requirements currently rests, under authority delegated from time to time, with the Accounting Safeguards Division of the FCC Common Carrier Bureau ("CCB") and related divisions at the State Commission level. The changes recommended herein will undoubtedly have an impact on the role of the accounting and audit staffs of the FCC and state commissions.

The current responsibilities of the FCC's Accounting Safeguards Division include:

- Development of accounting and reporting processes to measure the impact of FCC pronouncements.
- Administration of the USOA, including related accounting and recordkeeping requirements.
- Conduct of field audits and investigations of carriers' financial and operating practices, procedures and records.
- Reporting and distribution of accounting, statistical, service quality and infrastructure information.
- Setting of LEC interstate depreciation rates.

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Within the Accounting Safeguards Division, the FCC Audits Branch is responsible for the identification of, in conjunction with other CCB divisions, requirements for field investigations and audits (recurring, periodic and one-time) in support of accounting and structural safeguards, cost allocations, affiliate transactions, service quality reporting program, and infrastructure development program. The Audits Branch develops an integrated audit program, conducts field audits and investigations, conducts joint audits with State Commissions in areas of common interest, and establishes auditing procedures to determine compliance with the FCC's policy decisions and new initiatives in the area of industry structure.

The Reporting Management and Analysis Branch ("RMAB") of the Accounting Safeguards Division has the following mission statement:

> RMAB's primary mission is twofold: First, to address significant LEC issues in a manner that ensures that carriers are compensated fairly for their investment, that decisions are pro-competitive in a deregulatory environment, that quality services are maintained and available at reasonable rates, and cooperation and coordination with State Commissions on matters of their concern. Second, to obtain from the LEC industry the necessary and accurate data that will assist the Commission staff in making informed decisions in its public policy making process and to make that data easily available to Commission staff, State Commissions and other consumer and industry groups. It is our goal that such data will facilitate meaningful quantitative analysis, particularly with respect to economic, financial, engineering, universal service and service quality issues.

Impact of Changes in the Industry Environment on the Regulator's Oversight Role

In the current environment, detailed compliance auditing must give way to selective auditing of traditional regulated operations on a focused basis. The emphasis should shift to activities which further the regulators' role of implementing the new pro-competitive, deregulated environment and contribute to the overall growth of the telecommunications marketplace. The shift to a competitive marketplace should be accompanied by a shift to a business-risk oriented audit approach with emphasis on implementation of new regulatory and legislative initiatives instead of historical audit procedures focused on regulatory accounting and recordkeeping practices.

The role of the regulator in a competitive environment should be different from that role in a regulated environment. Information considered non-sensitive in a regulated environment becomes proprietary in a competitive world. That is not to say there is no role for a regulator in a competitive world. However, the type of information or data requests should be tailored to fit the regulatory mission. The missions of the regulatory staffs should be synchronized with that of the Commission.

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The current roles and responsibilities of the branches within the Accounting Safeguards Division embrace the need to assist the Commission in carrying out its responsibilities. Our recommendations to streamline the Part 32 accounting and affiliate transaction rules and the recordkeeping related to BPRs and depreciation should reduce the level of information required to be reported on a periodic or annual basis. However, the current level of detailed data submissions and related accounting requirements seem inconsistent with the FCC's current regulatory role. In fact, many reporting requirements are only relevant in a cost-based rate regulated environment.

Rather than requiring the reporting of detailed information on a regular basis, information should be requested by the staffs only on an "as needed" basis. Assuming some level of FCC staff effort has been required to process, analyze, compile and file these regular submissions, this is a time consuming and costly exercise. Are these efforts truly consistent with the goals of present regulation and are they value-added? The flexibility of the staffs should improve as they can investigate specific issues or results through a data-request procedure as opposed to the current approach of requesting significant amounts of reporting, performing trend analysis on such reports and requiring explanation of account variations. Staffs should be able to devote more time to the issues that really matter to all interested parties.

As described above, one of the responsibilities of the staff is to collect accounting, statistical, service quality and infrastructure reports from carriers. The ARMIS reports are among the reports required. We do not disagree with this responsibility—only the level of detail at which such information is being requested and reported. Such information was previously used in the rate making process to determine the appropriateness of costs for inclusion in the revenue requirement. Comparison of similar cost levels among "like" carriers was a useful exercise in determining cost recovery. However, with the setting aside of revenues based on costs, such information is less relevant. If one carrier decides to incur a high level of costs on research and development, while another carrier decides to spend a high level of costs on marketing activities, and another decides not to expend costs in the area of customer service, that is their business. In a competitive market, customers will consider a variety of issues in selecting a product and, if a new product appeals to them or service levels are unacceptable, they will choose service from another competitor. Further, to the extent that the industry continues to become more competitive, the sensitivity of such information increases. If it is important for the accounting and audit staffs to obtain information on service levels to be able to provide a report to the Commission, they always have the option of requesting such information from the carriers.

In summary, in a changing telecommunications world, the role of the regulator should also change. Flexibility in the accounting and audits staffs work efforts is desirable. Rather than require communications companies to establish systems and processes to accumulate and report significant volumes of information to the FCC, the staffs should determine which information is required to achieve a specific objective, justify the request, and request only that information from the carriers. The needs will change from year to year depending on a number of factors, and carriers should be able to provide the requested information in a reasonable time frame.

State Regulators' Simplification Efforts

It is important that any revisions in the level of information requested from carriers by the FCC staff be coordinated with the State Commissions. If a "streamlined" ARMIS procedure is adopted by the FCC, changes in the carriers' reporting processes to be responsive to such streamlining would likely result. However, if State Commissions continue to require the reporting of ARMIS information at the current level, a layer of additional cost to the carrier would likely result. Instead of reducing the effort necessary to comply with regulatory oversight (in an increasingly competitive environment), more effort would be required. For this reason, coordination between the FCC and State Commissions is clearly necessary. Similar to the FCC, State Commissions should have to justify requests of carriers under competition. As the shift from cost-based rates increases, the sensitivity of cost information becomes less relevant to the regulators and such information becomes more sensitive to competitors.

The proposed changes herein should not pose an undue hardship on the State Commissions. The State Commissions already collect the majority of their accounting information using the Class B chart of accounts under Part 32. The majority of states (32 in total) have adopted price cap regulation without earnings sharing similar to the FCC. In fact, many states have already granted flexibility in the depreciation rate setting process and have streamlined regulatory reporting processes.

VIII. OVERALL SUMMARY

The recommendations contained in this paper provide a forward-looking blueprint to guide the transition from regulation to competition.

The Part 32 rules do not reflect the existing regulatory and competitive paradigm and as such impose an unnecessary and costly constraint on the carriers subject to its requirements. Such requirements should be streamlined and/or eliminated in order to provide subject carriers the increased flexibility necessary in today's competitive environment and to move the LEC industry towards accounting and recordkeeping practices (GAAP) utilized by companies outside of the local exchange telecommunications industry.

The accounting rules embodied in Part 32 (in particular the level of accounting and recordkeeping specificity required) were developed principally to support rate of return regulation in the absence of competition. As all LEC Coalition members and many other large LECs have adopted price cap regulation without earnings sharing in the interstate jurisdiction (and in 32 state jurisdictions), and as increased competition is the overall goal of the Telecommunications Act, those accounting and recordkeeping requirements designed in support of traditional rate of return regulation are no longer necessary.

The USOA imposes significant recordkeeping requirements on subject carriers that carry with them significant costs of compliance. The benefits associated with continuing many of these requirements are either spent, as demonstrated in this paper, or unclear. Further, competitors to the LECs are not subject to the same USOA requirements but must comply with only GAAP. These "costs of regulation" are very real and must be considered in today's competitive environment.

We recommend that the Commission adopt the recommendations contained in this paper now with the long-term objective of allowing the Coalition LECs to fully adopt GAAP consistent with companies outside of the local exchange carrier industry. The short-term recommendations described in the preceding sections of this paper should be implemented immediately and provide the basis for the transition to full reliance on GAAP for accounting, recordkeeping and reporting purposes in the telecommunications industry.

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